compliance, the information that was discovered about Verizon's affiliate practices are sufficiently egregious to require the Commission to impose a substantial remedy and penalty.

A. General Flaws In The Audit Procedures

In a number of instances, the audits contained flaws that pervaded nearly all of the objectives that the audit sought to assess Most fundamentally, the auditors elected to assess Verizon's compliance with a number of section 272 obligations by using statistical sampling procedures, rather than examining all elements or units within the given population to be assessed However, as the attached declaration of Dr Robert Bell explains, the audits consistently violated accepted sampling techniques, including use of samples that were too small or did not represent the larger population to be examined. Additionally, it is often simply impossible to verify the accuracy of the results reported by the auditor, because the audit reports failed to collect or to disclose even basic data regarding the samples – such as standard deviations and population sizes – that are critical for assessing the validity of the statistical results *See* Bell Decl ¶¶ 39-46, *see id.* ¶¶ 15-23 (discussing proper sampling techniques) Given the heavy reliance on sampling in these audits, these fundamental statistical errors preclude any finding that Verizon has complied with the requirements of section 272

Second, Verizon often failed to maintain, and the auditor often failed to collect, information required for valid audit conclusions Thus, as discussed below, Verizon failed to keep performance data that would directly demonstrate whether Verizon favored its section 272 affiliates over competitors Likewise, substantial documentation, including title documents, invoices, and internal policies and procedures that would undoubtedly assist in any assessment of Verizon's cost allocation practices were either not maintained or not collected

This missing information often resulted in an examination of Verizon's compliance for only a limited period of time Thus, even though the audits purported to evaluate a full one year period (*see* Auditor's Initial Biennial Report, Cover Letter), there were in fact a variety of instances where the audit evaluated far shorter periods – much of the performance data, for example, existed only for a few months Certain credit reports were obtained for just one month – September, 2000 *See, e g.*, *id.* App A, at 8 These sorts of practices not only are inconsistent with the purposes of the biennial audit, but send a troubling signal to the BOCs that compliance is necessary only for the short period the auditors choose to assess

Moreover, the audits *never* appeared to examine Verizon's compliance with section 272 *prior* to its interLATA approval, even though AT&T has previously documented that there have been substantial pre-approval transactions among Verizon and its section 272 affiliates *See, e g.*, Affidavit of Robert E Kargoll, *Application by Bell Atlantic-New York For Authorization Under Section 271 In The State Of New York*, CC Docket 99-295, at 31-32 (filed Oct 19, 1999), *see also* Comments of MCI Telecommunications, AAD No 97-83, at 3-6 (filed Sept 15, 1997) As a result of this practice, Verizon could freely have engaged in illegal cross-subsidization prior to 2000, and yet the audit could not have detected such conduct – which, again, sends a signal to other BOCs that such pre-approval misconduct will likely go unsanctioned

Third, the audits generally failed to investigate complaints against the BOCs that allege violations of section 272 In numerous instances, the auditors requested information about all complaints against Verizon or its affiliates, and yet a large number of the complaints are not even discussed in the audit report *E.g.* Auditor's Initial Biennial Report, App A, at 31, 41 The importance of investigating all formal allegations of violations of section 272 should be readily apparent, and the failure to do so renders any findings of compliance meaningless

B. <u>Anti-Discrimination Provisions</u>

The audits fail to demonstrate that Verizon complies with its nondiscrimination obligation to provide the "same treatment" to its section 272 affiliates and to unaffiliated competitors. *Non-Accounting Safeguards Order* ¶ 204 Pursuant to the *General Standard Procedures*, the audits purported to examine compliance with five "objectives" that relate to section 272 nondiscrimination obligations Auditor's Initial Biennial Report, App A, at 2 However, there are significant flaws in the standards and procedures used to measure Verizon's compliance with each of these objectives Despite these flaws, the audits uncovered significant discrimination in favor of Verizon's section 272 affiliates, which must result in penalties that are sufficient to remedy the harm caused to Verizon's competitors and to deter Verizon (and other BOCs) from engaging in such discriminatory conduct in the future. The Commission has not hesitated to impose penalties in similar circumstances where a BOC violates core antidiscrimination requirements *See, e g.*, *SBC Communications Inc.*, File No EB-00-IH-0326a (Feb 25, 2002) (imposing forfeiture on SBC of $84,000 for failure to comply with internet posting requirements for collocation), *Bell Atlantic-New York Authorization Under Section 271*, File No EB-00-IH-0085 (March 9, 2000) (order approving consent decree providing that Verizon will pay at least $3 million for lost or mishandled orders submitted by Verizon's local service competitors), *SBC Communications Inc.*, File No EB-00-IH-0030 (Jan 18, 2002) (proposing $6 million forfeiture against SBC for failure to abide by pro-competitive merger condition), *SBC Communications Inc.*, File No EB-00-IH-0432 (May 29, 2001) (forfeiture of $88,000 where audit uncovered material violations of merger condition relating to performance data)

1. Even The Incomplete Performance Measures Used In The Audits Show Discrimination In Providing Special Access And Other Key Services Used To Provide InterLATA Services.

Under section 272(e)(1), a BOC must "fulfill" all "requests" by competing carriers for "exchange access" and other services under the same time standards that it provides to its section 272 affiliates The Commission has emphasized that "the term 'requests' should be interpreted broadly" to include, at a minimum, "initial installation requests, subsequent requests for improvement, upgrades or modifications of service, or repair and maintenance of these services" *Non-Accounting Safeguards Order* ¶ 239 For these and any other "equivalent requests," the Commission's rules require that "the response time a BOC provides to unaffiliated entities should be no greater than the response time it provides to itself or its affiliates" *Id.* ¶ 240 Furthermore, "the BOC must make available to unaffiliated entities information regarding the service intervals in which the BOCs provide service to themselves or their affiliates." *Id.* ¶ 242.

Pursuant to these rules, a BOC must rely on well-defined measurements to demonstrate that its performance in fulfilling competitors' "requests" is nondiscriminatory Where robust measurements are used, the Commission and other interested parties can readily determine whether a BOC's affiliates are obtaining key inputs used in providing long distance, such as special access services, under more favorable conditions than unaffiliated carriers [10] The audits for Verizon's 272 affiliates, however, failed to use proper measurements, which could mask much discrimination. However, even the more limited data that was collected confirms that Verizon's performance was consistently biased in favor of its affiliates

The audits collected data for six measurements that Verizon relied upon for a section 271 application filed for Massachusetts Auditor's Initial Biennial Report, App. A, pp 32-33, Table 13 & n 5 Five of the measurements related to special access services (four of which included

[10] *See Non-Accounting Safeguards Order* ¶ 243 ("If competitors can easily obtain data about a BOC's compliance with section 272(e)(1), this increases the likelihood that potential discrimination can be detected and penalized, this, in turn, decreases the danger that discrimination will occur in the first place")

data for a subset of special access services called "high speed" special access) and one measurement related to PIC change intervals [11]

By way of comparison, the New York Public Service Commission (NYPSC) issued an order in June, 2001, that required Verizon to provide special access performance measures that were far more detailed than the measures in the audit *NYPSC Special Access Order* at 20-28 The NYPSC also used five metrics, but required Verizon to disaggregate the data on a variety of factors so that "parity comparisons can easily be made" In the audits, by contrast, the data was not broken down by the capacity level of the service (e g , DS0, DS1 and DS3 and above), making comparisons more difficult [12]

Moreover, the audit measurements also differ from those that were proposed for use in biennial audits in the *General Standard Procedures* In many cases, the audit measurements are defined in a different manner Such definitional changes can often be significant, and allow a carrier to hide discriminatory conduct Equally as troubling is the reason why different measures

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[11] PIC changes are the method by which a customer changes its primary long distance carrier The BOC implements PIC changes, and it has obvious incentives to use the PIC change process in myriad ways to favor its long distance affiliates This includes implementing PIC changes more quickly, but also includes additional forms of discrimination, like routinely placing a "PIC freeze" (a process which makes it more difficult for a customer to change its local carrier) on customers that select its affiliates' long distance services The audits did not even purport to assess this type of discrimination, even though AT&T suspects Verizon is engaging in this very conduct *See* Letter of Harry M Davidow, AT&T, to Hon Janet H Deixler, New York, P S C , Cases No 00-C-0897 et al (Jan 18, 2002)

[12] Moreover, the audit itself concluded that certain measures reported by Verizon appeared unreliable The auditors attempted to verify the accuracy of Verizon's reports by examining the underlying data – although not in the manner required by the *General Standard Procedures* *See General Standard Procedures*, Objective VIII, Procedure 4) Thus, the auditors were told by Verizon that, "due to data archiving procedures, underlying transaction data" for most measures was "unavailable" for many periods Auditor's Initial Biennial Report, Appendix A, Objective VIII, Procedure 4 at 38 For data that was available, the auditors attempted to reconcile the underlying data with the data reported, and found discrepancies, which further undercuts the reliability of the measures used in the audits *Id* at 39

had to be used in the audits Verizon simply failed to collect or maintain the data that is necessary to measure its performance And the data that was maintained was often kept for a period shorter than the nine months that the audits attempted to examine One special access measure, for example, relied on data that was kept for only six months, and the PIC change data was available only for a five month period Auditor's Initial Biennial Report, Appendix A, Objective VIII, Procedure 3 at 33 These deficiencies preclude any finding that the audits' performance measures could demonstrate that Verizon was complying with its obligations throughout the audit period.[13]

Even though the audit measurements are insufficient to show that Verizon complied with its nondiscrimination requirements, the data that was produced confirms that performance was in fact discriminatory Significantly, these data reinforce the findings of the NYPSC, which concluded, just days before release of the audits, that Verizon failed to refute "evidence indicating that it provides special [access] services in a discriminatory manner" *NYPSC Special Access Order* p 6 That is also the inescapable conclusion from even the most cursory review of the audit measurements Thus, as Dr Bell explains, the data show, for example, that installation of special access services for non-affiliated carriers took far longer than for Verizon 272 affiliates in June, 2000, the mean for installation of high speed special access for Verizon affiliates was just 9 9 days, but was 25 3 days for competitors Bell Decl. ¶¶ 43-44 And for PIC changes, the evidence of discrimination is even stronger in all of the five reported months, it took longer for Verizon to implement competitors' PIC changes than those of Verizon's

[13] Notably, the *General Standard Procedures* required the auditors to obtain the written methodology that the BOC follows to document the "time intervals for processing orders" and, "[i]f the company does not have any written procedures[, to] inquire and document why." *General Standard Procedures*, Objective VIII, Procedure 4 Here, Verizon simply informed the auditors that it did not prepare such methodologies, and no explanation for that deficiency was ever sought Auditor's Initial Biennial Report, Appendix A, Objective VIII, Procedure 3 at 33

affiliates *Id* ¶ 45 In July, for example, the difference was over three times as long – nearly two hours for competitors, and just 39 minutes for Verizon's 272 affiliates [14]

In fact, review of virtually *every* measure indicates that Verizon's affiliates received more favorable service than competitors *See* Table 14a, 14b 14c Thus, for the average installation intervals, Verizon affiliates received systematically better service from Verizon than competitors. In six of the nine months surveyed, the results showed that the 272 affiliates' orders were installed faster (results in days)

	High Speed Access		All Special Access	
	Verizon 272	Competitors	Verizon 272	Competitors
March	15 5	28.6	15 2	23.9
April	17 0	23 8	12 3	21.4
May	23 2	38 0	23 2	31 4
June	9 9	25 3	9 9	22 5
July	21 0	32.8	19 0	29 0
Sept	30 0	59 2	30 0	48 1

See Table 14a As this chart indicates, in the last month for which data was collected, it took Verizon nearly *two months* to install high speed special access circuits for competitors – twice as long as for its own 272 affiliates

Likewise, on the measure for Percent Commitments Met, there was again consistent bias in favor of the 272 affiliates in a number of months, they received 100% on-time performance from Verizon, but competitors never received this level of performance And once again, in six of the nine months, Verizon's 272 affiliates received more timely service than competitors (figures in percentage of commitments met)

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[14] Verizon claims that this difference in performance is immaterial because long distance carriers expect only that PIC changes will be completed in 24 hours Response p 7 But that does not explain the consistent and significant bias against unaffiliated carriers, to the contrary, it suggests that Verizon's control of the PIC process affords it a broad ability to favor its own affiliates. As described above, such favoritism includes both delayed processing of PICs and other forms of discrimination. Thus, these findings bolster claims that Verizon abuses the PIC process and demands a more thorough inquiry of its power to control PIC processing.

	High Speed Access		All Special Access	
	Verizon 272	Competitors	Verizon 272	Competitors
Feb	100%	83 9%	100%	84.4%
March	92 3%	85 7%	93 8%	87 6%
May	90.9%	85 0%	90.9%	85.9%
June	90.4%	82.2%	83 8%	83.8%
July	100%	77 7%	75 0%	80.0%
Aug	100%	72 5%	100%	72.8%

Id. Table 14a

And for trouble tickets, the 272 affiliates had just nine reports in all, while competitors always had thousands per month – which is itself a troubling fact indicating favoritism *Id.* And for the repair interval on trouble tickets, the average interval was longer for competitors in the two months for which comparisons can be made *Id.*

In its response to the audits, Verizon claims that this "stare and compare" approach is not reliable, particularly given the small volumes for certain of the audit measurements Verizon Response p 6 But as Dr Bell explains, even though the audit measurements are too crude to permit use of basic statistical tests that would avoid a "stare and compare" approach, there is virtually no doubt that, if adequate data had been disclosed, it would show the results for many measures to be statistically significant Bell Decl. ¶¶ 43-46 For these reasons, there is more than a firm basis to conclude that Verizon has systematically discriminated against the competitors of its Section 272 affiliates in providing services that these carriers both need to compete against one another in the long distance market

And in all events, Verizon's complaint (p 6) that the performance data should be disregarded because of the "small volumes of orders" for the 272 affiliates is effectively a concession that the audit was inadequate and should be repeated Neither Verizon nor the auditor ever explains why these volumes are so small, and the obvious remedy is to collect data until there is a sufficient amount upon which to base a determination of Verizon's compliance with section 272's nondiscrimination obligations

2. Discrimination In the Provision of Goods And Services

Under section 272(c)(1), BOCs cannot discriminate in the "provision of goods, services, facilities and information" This is a broad and general anti-discrimination provision, and the audits attempted to assess Verizon's compliance with it through a number of inquiries Audit Report, App A at 27-30 In almost all instances, however, these inquiries were structured in way that could very likely fail to detect significant discriminatory conduct For example, as Dr Bell describes, pursuant to the *General Standard Procedures*, the auditors were required to select a "statistically valid" sample of purchases of goods or services from the BOC by unaffiliated carriers, and then compare the rates, terms and conditions of those purchases to purchases of the same goods made by the Verizon 272 affiliate Bell Decl ¶¶ 30-31 However, instead of a simply random sample of purchases, the auditors selected what is known as a "cluster sample" As Dr Bell explains, such a sample could not be expected to satisfy the precision requirements for a statistically valid sample *Id*

Another striking example of the audits' flawed approach is its effort to assess Verizon's compliance with the section 272(c)(1) requirement that a BOC's sales representatives must inform new customers that, in addition to the BOC's affiliates, other carriers provide long distance services Auditor's Initial Biennial Report, App A, at 29-30 The *General Standard Procedures* required only that the auditors listen, for just a half-hour, to calls received by five randomly selected representatives at each of three of the BOC's call centers *General Standard Procedures*, at 37 However, this recommended process, even if followed by the auditor, could never adequately demonstrate Verizon's compliance with these nondiscrimination requirements To assess compliance would require, at a minimum, obtaining a statistically valid sample of calls

– but the recommended process simply requires observations to occur over a given time period – and a short one at that Indeed, the audit report never discloses the number of calls that were monitored, and it appears that the total could be as low as *five* calls [15] As Dr Bell explains, for this and other reasons, that cannot be a valid sample Bell Decl ¶¶ 37-38 Even though only a few calls were observed, the auditors nevertheless found that one customer "was *not* informed of other providers of interLATA services and was *not* informed of his right to make the selection " Auditor's Initial Biennial Report at 29 Of course, this single call could be an aberration, but the fundamental problem is that the audits simply were not designed to properly assess compliance with this duty – a serious flaw that is all the more troubling given Verizon's past pledges that this biennial audit would "fully test" its compliance with these section 272 requirements.

C. Anti-Cross-Subsidization Provisions.

Section 272 contains numerous "provisions that are intended to deter cross-subsidization by the BOC" and, as the Commission has stated, "we must know whether the BOCs are complying with them " *Accounting Safeguards Order* ¶ 202. As a consequence, one of the critical purposes of the audit report is to "address whether the carrier has complied" with these anti-cross-subsidization provisions *Id* Here, the auditor simply failed specifically to address Verizon's compliance with these parts of section 272 Moreover, although the auditors examined "objectives" that purported to assess Verizon's compliance with various structural requirements and cost allocation rules, in fact the audits suffered from a number of

[15] Notably, the auditors in the Verizon audits did not follow the recommended procedures they observed only five representatives *total*, not fifteen (i e., five at three call centers) Moreover, according to the audit report, these five representatives were viewed "remotely" – a vague term that is not defined but that may have altered the results Moreover, the report states that of the five representatives initially selected, only three received calls and therefore two additional representatives were substituted One inference that could be drawn is that each representative received a single call

methodological defects Nonetheless, even the superficial analysis that was conducted again revealed numerous violations

In fact, in at least two instances, the audit revealed that Verizon violated one of the most fundamental requirements of section 272 that the BOC may not provide interLATA services directly, but rather only through a section 272 affiliate. 47 U S C § 272(a) First, even months after the Bell Atlantic-GTE merger, Verizon failed to transfer a contract for interLATA services from a GTE company to a section 272 affiliate Auditor's Initial Biennial Report, Appendix C/Attachment II Second, a number of circuits which should have been provisioned through a Section 272 affiliate were in fact identified as having been provided through another Verizon affiliate [16] These violations of a most basic obligation of section 272 reflects Verizon's cavalier approach to its compliance

1. "Operate Independently."

Section 272(b)(1) requires the interLATA affiliate to "operate independently from the Bell Operating Company" 47 U S C § 272(b)(1) The Commission has explained that this requirement encompasses four "important" restrictions (1) no joint ownership of switching and transmission equipment, (2) no joint ownership of land and buildings housing such facilities; (3) no provision of operations, installation and management ("OI&M") services by the BOC to the affiliate, and (4) no provision of OI&M by the affiliate to the BOC. *See Non-Accounting Safeguards Order* ¶ 163, *BA-NY Order* ¶ 406

[16] Auditor's Initial Biennial Report, Appendix C/Attachment II The circuits were provisioned through Telecommunications Services Inc (TSI), an affiliate for which, as noted above, no audit was performed It is not clear whether TSI would be, apart from these services, considered a section 272 affiliate. Regardless, Verizon violated section 272 it violated either section 272(d) by failing to pay for an audit of TSI (*see below*) or section 272(a) by providing interLATA services directly through a non-272 affiliate

The proposed audit model indicated that the auditor should review OI&M procedures, as well as switch collocation agreements The audit, however, contains almost no examination of these issues. *See, e.g.*, Auditor's Initial Biennial Audit Report, App A, at 5-6 In particular, as to OI&M services, the audit analyzes sets of services that it classifies only as "Technical Services" or "Telecommunications Services " These undefined categories are wholly inadequate to ascertain whether such services, rendered by the BOCs to the interLATA affiliates,[17] constitute or include prohibited OI&M services Given the Commission's prior findings that joint provision of OI&M services creates "substantial opportunities for improper cost allocation" and would "*inevitably* afford the affiliate access to the BOC's facilities that is superior to that granted to the affiliate's competitor's," *Non-Accounting Safeguards Order* ¶ 163, the audits' procedures to assess Verizon's compliance with this significant and ironclad rule were plainly inadequate

As to the joint ownership prohibition, there were serious deficiencies in the collection and reporting of assets First, Verizon provided the auditor with an incomplete list of fixed assets, because it excluded "construction in progress" – *i.e.*, assets not yet placed in service The assets were discovered only because the auditor, comparing the general ledgers with Verizon's list of assets for all three Section 272 affiliates, noted a discrepancy in the fixed asset balance between the two[18] In addition, Verizon excluded land and buildings because they were leased by

[17] *See* Auditor's Initial Biennial Report, Appendix A, Objective 1, Procedure 4 (services also not listed in terms of *each* Section 272 affiliate) This inadequate description of services is also the basis for the auditor's *pro forma* assertions in Objectives V & VI about compliance with the affiliate transaction rules *Id*, Objective V & VI, Procedure 5 (where, inter alia, identification of the type of service involved was required)

[18] The auditor noted a further discrepancy with respect to BACI, which Verizon indicated was for a credit related to the purchase of long distance cable, a transmission facility This deficiency also affected compliance with section 272's accounting safeguards

BAGNI, ostensibly from unaffiliated entities The auditor should have verified such assertions in light of previous evidence of indirect leasing by Bell Atlantic to BAGNI through an unregulated affiliate [19]

Second, the auditor also failed to audit any title documents for transmission and switching facilities, as required by the *General Standard Procedures* (Procedure 7), because Verizon asserted that title documents did not exist for these assets [20] Instead, the auditor inspected only invoices [21] In addition, the auditor took only a random sample of facilities with a cost value over an undisclosed amount, and it did not sample or audit any assets below that amount, although required to do so by the *General Standard Procedures* Initial Biennial Report, Appendix A, Objective I, Procedure 7 As more fully explained in the accompanying declaration of Dr Bell, the auditor performed only a portion of the sampling required and the audit fails to disclose critical data, such the size of the universe and the standard deviation used [22]

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[19] *See* AT&T's *Ex Parte* submission (filed Nov 8, 1999), *In the Matter of Application by Bell Atlantic New York for Authorization Under Section 271*, CC Docket No 99-295

[20] *See* Initial Biennial Report, App A, Objective I, Procedure 7 (BAGNI transmission and switching facilities, including capitalized software), GTOC/VSSI Audit, Supplemental Biennial Report, App C, Objective I, Procedure 7 (for the 15 items related to transmission and switching facilities)

[21] In the GTOC/VSSI Audit, the auditor looked at Display Asset Accounting Documents that identified the company from which, and to which, the asset was transferred Supplemental Biennial Report, Appendix C, Objective I, Procedure 7 Moreover, the auditor in the BA 272 Affiliate Audit looked at invoices from July 1998 through July 2000 (*see* Initial Biennial Report, Appendix A, Objective I, Procedure 7), even though it should have looked at invoices from the date of the enactment of the Telecommunications Act in 1996 through the end of September 30, 2000 Auditor's Supp Biennial Report, Appendix C, Objective I, Procedure 5, text at Table 7

[22] The BA 272 Affiliate Audit states that Verizon provided the auditor "a full description of each item, location, date of purchase, price paid and recorded, and from whom purchased or transferred" as required by the *General Standard Procedures*, but that information is not disclosed other than an assertion that "the date of purchase or transfer listed on the BAGNI fixed asset detailed listing ('the transaction date') was January 1, 2000, for the transmission and

2. "Separate Books, Records and Accounts."

Section 272(b)(2) requires an interLATA affiliate to "maintain books, records, and accounts in the manner prescribed by the Commission that are separate from the books, records, and accounts maintained by the Bell Operating Company of which it is an affiliate" 47 U S C. § 272(b)(2) The Commission has found that the affiliate must maintain its books, records, and accounts in accordance with Generally Accepted Accounting Principles (GAAP) *Accounting Safeguards Order* ¶ 170 The audit contains numerous deficiencies, however, which make it impossible to ascertain whether or not Verizon has complied with these requirements

For example, in stark contrast to the proposed model audit, the actual audit does not "assess and test the adequacy of internal controls," it does not "determine whether there is a clear and complete documentation of the manner in which the affiliate's accounting system flows into the BOC's Part 32 accounts," nor does it provide a "detailed description of [the affiliate's accounting] system and why it does or does not conform with GAAP" *See Proposed Model Audit* ¶ 3 (Requirement II) The auditor also failed to comply with the minimal requirements of the *General Standard Procedures* For example, the auditor did not examine all of the cash receipts (as required by Procedure 3 of the *General Standard Procedures*), but instead looked at only 10 cash receipts [23] The auditor also looked at "10 cash disbursements (*including* 5 payroll) transactions"[24] when it should have selected "10 cash disbursements *and* 5 payroll transactions"

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switching facilities because Bell Atlantic was first allowed to offer in-region long distance service in January 2000" Auditor's Initial Biennial Report, App A, Objective I, Procedure 7

[23] *See* Auditor's Initial Biennial Report, Appendix A, Objective II, Procedure 3 The same was true with respect to the GTOC/VSSI Audits Auditor's Supplemental Biennial Report, Appendix C, Objective II, Procedure 3, *but see* Merger Compliance Report, Objective II, Procedure 4 stating that the auditor selected "one cash receipt, cash disbursement and payroll transaction each" to perform a "walkthrough" of each transaction

[24] *Id.* (emphasis added)

See General Standard Procedures, Objective II, Procedure 3 (emphasis added). As shown by Dr Bell, this substantially distorts the sample results [25]

3. "Separate Officers, Directors, and Employees."

Section 272(b)(3) requires an interLATA affiliate to "have separate officers, directors, and employees from the Bell Operating Company of which it is an affiliate" 47 U S C § 272(b)(3) The audit once again contains numerous deficiencies that preclude any finding of compliance with these requirements

First, the *Proposed Model* would have required the auditor to "list services performed by the affiliate by BOC employees and those services performed by the affiliate employees for the BOC" and to "[c]ompare services performed to billings to verify they are being charged to the appropriate entity" The auditor did not perform such an analysis Thus, the audit provides no basis to assess Verizon's performance on these critically important factors

Second, the auditors also assert that that "they obtained the BOC's and Section 272 affiliates' policies and procedures,"[26] but the auditors do not state whether or not such policies were written Indeed, it is likely that they were not Non-written "policies" may in fact reflect "ad hoc" policies that shift depending upon who is inquiring.[27]

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[25] In the BA 272 Affiliate Audit, the auditor also did not, as required by the *General Standard Procedures* (Objective II, Procedure 2), separately document its understanding of each affiliate's written accounting procedure and policies, instead a single description is provided for all three Auditor's Initial Biennial Report, Appendix A, Objective II, Procedure 2 In the GTOC/VSSI Audit, the auditor "requested from management but did not receive the fair market values of the properties or equipment necessary to assess conformity with GAAP" and so could not make that determination Auditor's Supplemental Biennial Report, Appendix C, Objective II, Procedure 4

[26] Auditor's Initial Biennial Report, Appendix A, Objective III, Procedure 1

[27] In the GTOC/VSSI Audit, the auditor found no written policies or procedures regarding loaned or shared employees, and Verizon took the position that "there was no need for written policies or procedures" Supplemental Biennial Report, Appendix C, Objective III, Procedure 1

Third, the *General Standard Procedures* required the auditor to "[d]ocument in the report number of employees on both [BOC and Section 272 affiliate employee] lists and if any of these individuals were on both lists at the same time " *General Standard Procedures*, Objective III, Procedure 4 The auditor implemented this requirement by taking, in one of the audits, random samples, rather than by actually comparing the complete lists of employees It is impossible to determine, however, whether the random sample was statistically valid (as required by Objective III, Procedures 5 and 6 of the *General Standard Procedures*), because of the absence of data regarding the universe from which the sample was taken and the standard deviation [28] As Dr Bell explains, no meaningful conclusions can therefore be drawn from these sample results

Finally, two potential violations of this requirement were not adequately pursued First, the auditor did not pursue Bell Atlantic's concession that an officer of at least one interLATA affiliate appeared on both the Consents of the Section 272 Affiliates and on the Minutes of the Bell Atlantic Boards of Directors meeting Auditor's Initial Biennial Report, Appendix A, Objective III, Procedure 2 Second, the auditor also found that Bell Atlantic's "earnings per share is a component of the financial portion of the annual bonus calculation for officers and management employees of the Section 272 affiliates" Auditor's Initial Biennial Report, Appendix A, Objective III, Procedures 7 This intermingling of earnings for purposes of calculating bonuses clearly violates the "operate independently" requirement, yet the auditor did not pursue the matter, concluding without explanation that the "calculation of bonuses is not

[28] The auditor noted that 160 employees appeared on both VSSI's and the GTOCs' listing, but rather than determine whether "any" of these employees were on the list at the same time, the auditor limited its audit to a "random sample of 25 employees" Auditor's Supplemental Biennial Report, Appendix C, Objective III, Procedure 4. "Any" means any, and all 160 should have been investigated

tied" to the "combined performance of the BOC and the Section 272 affiliates " This process squarely contradicts the mandate in the *General Standard Procedures*, which provides that "[i]f the calculation of the annual bonuses is tied to the performance *of the BOC*," then the auditor should "obtain actual calculations used to determine the annual bonuses paid to all officers and senior managers and a representative sample of middle and lower level managers " *General Standard Procedures*, Objective III, Procedures 7 Because of the plain violation and the failure to conduct any follow-up inquiry, Verizon should be deemed to have violated this aspect of section 272

4. "Recourse to BOC Assets."

Section 272(b)(4) provides that an interLATA affiliate "may not obtain credit under any arrangement that would permit a creditor, upon default, to have recourse to the assets of the Bell operating company " 47 U S C § 272(b)(4), 47 C F R § 53 203(d) In the *Non-Accounting Safeguards Order*, the Commission interpreted this provision to prohibit a BOC, the parent of a BOC, or a non-section 272 affiliate of a BOC from co-signing a contract or other instrument with its Section 272 affiliate that would permit a creditor recourse to the BOC's assets in the events of default by the Section 272 affiliate *Non Accounting Safeguards Order* ¶ 189

In the BA 272 Affiliate Audit, the auditor failed, as required by the *General Standard Procedures* (Objective IV, Procedure 3), to conduct a sample of non-major suppliers of goods and services (*i e* , those having $500,000 or less in annual sales to the Section 272 affiliates, or $375,000 for the nine month period) and lease agreements, where the annual obligation is $500,000 or less Initial Biennial Report, Appendix A, Objective IV, Procedure 3 Moreover, when the auditor in the BA 272 Affiliate Audit sought confirmations from the "major" suppliers and lessors as required by the *General Standard Procedures*, less than half of the suppliers (34/78) responded None of the six lessors responded in the GTOC/VSSI Audit As Dr Bell explains, no meaningful conclusions can be drawn from these sample results, and the auditor's finding of compliance with Section 272 cannot be credited

5. "Transactions On An Arms' Length Basis."

Section 272(b)(5) requires an interLATA affiliate to "conduct all transactions with the Bell operating company of which it is an affiliate on an arm's length basis with any such transactions reduced to writing and available for public inspection" 47 U S C § 272(b)(5) The Commission has found that these requirements include three distinct obligations (1) the interLATA affiliate must provide, at a minimum, a detailed written description of assets transferred or services provided, and post the terms and conditions of the transaction on the company's home page on the Internet within 10 days of the transaction, (2) the descriptions "should be sufficiently detailed to allow [the Commission] to evaluate compliance with [the Commission's] accounting rules", and (3) the descriptions must be made available for public inspection at the BOC's principal place of business, and must include a statement certifying the truth and accuracy of such disclosures *Accounting Safeguards Order*, 11 FCC Rcd at 17593-94 [29]

AT&T previously identified a number of violations of these requirements in the New York Section 271 proceeding The Commission expressed its concern that Bell Atlantic failed to post all of its transactions on the Internet and failed to provide sufficient detail of such

[29] Specifically, disclosures should include a description of the rates, terms and conditions of all transactions, as well as the frequency of recurring transactions and the approximate date of completed transactions For asset transfers, the BOC should disclose the appropriate quantity and, if relevant, the quality of the transferred assets For the affiliate transactions involving services, the BOC should disclose the number and type of personnel assigned to the project, the level of expertise of such personnel, any special equipment used to provide the service, the length of time required to complete the transaction, whether the hourly rate is a fully loaded rate, and whether or not that rate includes the cost of materials and all direct or indirect miscellaneous and overhead costs *Second BellSouth Louisiana Order*, 13 FCC Rcd at 20790-95

transactions, and noted that "Bell Atlantic's Internet postings will undergo a *thorough and systematic* review in the Section 272(d) biennial audit, which will ensure that any failures to post are identified in time for appropriate remedial action." *BA-NY Order* ¶¶ 413-14 (emphasis added) That review has now occurred, and the audit has uncovered a continuing pattern of violations

Indeed, the audit identified a very broad range of violations – nearly 40 percent of the internet postings of contract summaries were determined to be insufficient, and nearly 20 percent of these non-compliant summaries had multiple errors.[30] In addition, there were numerous discrepancies between the affiliate's web postings and the written agreements, concerning such material terms as rates, descriptions of services, and indemnification of parties or personnel and their compensation [31] Many service agreements were posted on the web with pricing and other material information listed as "to be determined "[32] The audit also noted many instances in which the information was not posted within 10 days and where there were discrepancies between the posted transactions and those available for public inspection Although Verizon repeatedly shrugged off these violations as "administrative error," the audit demonstrates that these "errors" are too frequent and pervasive to be dismissed The Commission should take appropriate "remedial action" now that the biennial audit has identified these violations

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[30] The auditor reviewed 839 web postings of contract summaries: 304, or about 37 percent, failed to comply with the Commission's rules, Forty-four of these 304 postings contained multiple errors Auditor's Initial Biennial Report, App A, at 16-18

[31] *See* Auditor's Initial Biennial Report, Appendix A, Objectives V & VI, Procedure 6, Attachment I, Table 2

[32] *Id*, Table 6

6. "Valuation Methodology"

To ensure that the BOC complies with the obligation in section 272(b)(5) that all affiliate transactions occur at arm's length, the BOC must abide by the Commission's affiliate transaction rules *Accounting Safeguards Order* ¶¶ 121, 141-48. Those rules require BOCs to report transactions between regulated and non-regulated affiliates, and to value the cost of affiliate transactions in accordance with one of two valuation techniques – either Fully Distributed Cost ("FDC") or Fair Market Value ("FMV") *Id.*

The audit contains only general assertions that preclude any determination whether the BOCs' and the Section 272 affiliates' processes for developing FDC generally were accurate,[33] and it provides no basis for analyzing whether FDC with respect to the two services provided by the BOC to the Section 272 affiliate[34] and the one service provided by the Section 272 affiliates to the BOC[35] reflects an accurate calculation of FDC. The same is true of FMV [36] The auditor

[33] *Id.*, Objective V & VI, Procedure 7

[34] The two services were "Business Service Center/Account Team Center (General Business)" to BABS and "Sales/Service (Consumer Sales)" to BAC The costs for the first service included only unspecified labor costs (with a separate reference to the costs of Work Flow Management and an Incentive Program) and an order processing and two system costs. The costs for the second service included even less specific labor and systems costs

[35] That service was a strike-related service agreement where the ROI is unspecified

[36] Auditor's Initial Biennial Report, Appendix A, Objectives V & VI, Procedure 8 The two tested services provided by the BOC to the Section 272 affiliate were (1) utility service associated with a real estate lease, and (2) Wholesale National Directory Assistance to BAGNI The FMV for the former was based on the utility company's rate and actual monthly usage, while the FMV for the latter was based on responses to the related BAGNI Requests for Proposal

selected only two services for analysis, but did not provide an explanation of why its findings can in any way be generalized to other services [37]

The auditor also failed to collect data required under the *General Standard Procedures* Specifically, in the BA 272 Affiliate Audit, the auditor claimed that it could not obtain the FMV at the unit charge level for approximately 70 percent of the sampled transactions involving joint marketing services made available to the Section 272 affiliate but not to third parties The auditor also claimed that when it attempted to do so at the component level, for approximately 70 percent of the transactions, the auditor was unable to compare all of the components of FDC and FMV, including development and maintenance of customer database records and the customer complaint center "because the related services were unique to the company " Such components, however, are often benchmarked on an inter-industry basis, and the audit offers no explanation why that was not done here

Similarly, Verizon failed to produce data required by the *General Standard Procedures* The auditor could not determine whether certain fixed assets transferred to the Section 272 affiliates were "indirect" transfers from the BOC through another affiliate[38] because management was unable to locate third party and non-regulated affiliate invoices [39] To the extent there were fixed assets transferred to the Section 272 affiliates, the auditor was also required to, but did not,

[37] This same deficiency applies to the selection of the two services in the ILECs/VSSI Advanced Services Audit Auditor's Supplemental Biennial Report, Appendix F, Objective V &VI, Procedure 8

[38] Verizon, in its Response, asserts that the direct transferor was a non-regulated affiliated entity

[39] Auditor's Initial Biennial Report, Appendix A, Objective V &VI, Procedure 13 Verizon's Response stated that for eleven items the inability to locate the invoices related to a change of vendors, and that for the remaining three items, invoices for 86% were now located (but apparently not provided to the auditor) These unaudited responses should be verified and the explanation for the remaining 14% provided

"inquire and obtain details as to how the BOC made an equal opportunity available to unaffiliated entities to obtain ownership of the facilities" and to "[d]escribe how and upon what basis the BOC decided to transfer/sell the facilities to a Section 272 affiliate instead of an unaffiliated entity" *General Standard Procedures* at 35

IV. FUTURE AUDITS, INCLUDING A RE-AUDIT OF VERIZON, MUST BE PERFORMED UNDER DIFFERENT PROCEDURES

In addition to imposing proper penalties for Verizon's pervasive violations of section 272, the Commission should also take this opportunity to reinvigorate the biennial audit process to ensure that the standards and procedures employed will result in audits and audit reports that in fact allow the Commission, state commissions, and other interested parties to "have access to sufficient information to assess whether a BOC is adhering to the section 272 structural, transactional, and nondiscrimination safeguards" *Audit Data Disclosure Order* ¶ 7

A rigorous and thorough biennial audit provides significant benefits in detecting BOC discrimination and other anticompetitive conduct that poses a threat to competition on the level playing field that Congress intended Additionally, such a biennial audit also serves a broader purpose such audits could have a serious deterrent value, because BOCs will be more likely to follow their section 272 obligations if they expect a rigorous biennial audit. As the Commission has concluded, "[i]f competitors can easily obtain data about a BOC's compliance" with section 272, this "increases the likelihood that potential discrimination can be detected and penalized, this, in turn, decreases the danger that discrimination will occur in the first place" *Non-Accounting Safeguards Order* ¶ 243 These concerns are heightened for this audit of Verizon and its affiliates because this is the first such audit, it necessarily will provide significant guidance to the BOCs, to state commissions, and to competitors about how future audits will be conducted and about the vigor with which the Commission will enforce the pro-competitive provisions of section 272

With these principles in mind, the Commission should therefore set forth additional standards and procedures to be applied to future biennial audits, including a re-audit of Verizon and its section 272 affiliates At a minimum, the Commission should adopt the following guidelines.

First, the Commission should adopt a strong preference that the audit make a complete examination of the entire population of any transactions or data that the audit is assessing, rather than relying on sampling *See* MCI Proposed Audit Comments, AAD-97-83, at 6 (filed Sept 15, 1997) As these audits demonstrate, the use of any particular sampling technique is subject to significant dispute, and the results – particularly where insufficient information regarding the sampling is disclosed – are often inconclusive on issues that are central to section 272 compliance And sampling by definition introduces risks that violations will go undetected. Moreover, in the Verizon audit, sampling was performed even where a complete examination of all data would be practical For example, in determining Verizon's compliance with the "separate employees" requirements, the auditor inexplicably took a sample of the employees, even though performing a complete examination would not have been burdensome and even though a sample would by definition not detect whether Verizon's employees were truly separate *See supra* Part III C 3

Therefore, the Commission should adopt standards that address both when sampling is appropriate and that further define the specific sampling techniques to be used and the type of information that must be disclosed in the audit In particular, the Commission should require that, where sampling is performed, enough information is provided (*i.e.*, such as standard deviations and population sizes) to enable interested parties to determine if the data is statistically significant under various measures

Second, the Commission should explicitly delineate the periods that should be audited, and require the BOC to maintain all relevant data for those periods so that the auditors can properly assess compliance with the section 272 obligations Where the BOC fails to maintain or provide such data, the Commission should presume a violation of section 272 In particular, the Commission should preclude a BOC from, as Verizon did here, limiting the amount of data that it maintains, and then claiming that additional data would be necessary to verify any violations disclosed by the limited data The Commission should thus clearly state all data that must be maintained and collected, and then broadly define the time period so that all possible discrimination can be detected (thus maximizing the deterrent value of the audit) Additionally, the Commission must make clear that, for a BOC's initial biennial audit, the auditors will examine all transactions and data since the formation of any 272 affiliate, including periods prior to section 271 approval Most 272 affiliates begin providing interLATA service very soon after approval, and that necessarily requires that substantial activities between the BOC and those affiliates will occur prior to approval If these periods are not audited, it would allow the BOC a significant opportunity to mask cross-subsidization and other cost misallocation

Third, with respect to discriminatory conduct, the Commission should adopt rigorous, well-defined, and properly disaggregated performance measures Since the Commission first acted in 1997, a number of proceedings at the state and federal level have investigated proper performance measures, and the biennial audit process should rely on measures developed in those proceedings, where the measures are properly defined, apply a clear performance standard, and are subject to rigorous testing and are open to interested parties Use of such uniform measures would help to limit disputes during the process and to provide for consistent remedies where violations occur

Fourth, the Commission should substantially strengthen a number of the standards in the existing guidelines For example, the Commission should strengthen the standard to test compliance with section 272's requirement that a BOC provide certain inbound callers with information regarding their choice of providers for long distance service As described above, under the current *General Standard Procedures*, the auditors need only observe 15 callers for 30 minutes each, with no requirement about the number of calls that must be monitored. This standard could never adequately determine if the BOC is complying with its obligation Instead, the Commission should attempt to determine the entire population of calls received that fall within the section 272 obligation, and then using proper sampling techniques, set forth precisely how such samples should be obtained

Finally, the Commission should adopt guidelines for appropriate remedies and penalties for violations of the section 272 requirements Such guidelines would help ensure consistency, and would also aid in deterring violations, so long as the remedies and penalties were sufficiently strong

In this case, as stated above, Verizon's consistent and widespread violations of section 272 must be remedied with appropriate penalties Moreover, the substantial gaps and holes in the audit procedures also raise the possibility that these violations are representative of a greater pattern of cross-subsidization and discrimination against Verizon's competitors. As a consequence, Verizon and its affiliates should immediately be audited again using more fulsome procedures Indeed, re-auditing is essential – and in fact required by the terms of section 272 – in one respect no audit was even performed for one of Verizon's 272 affiliates

(Telecommunications Services Inc (TSI)), because Verizon did not disclose this affiliate's existence until days before the audit was released and months after the audit ended. *See Accounting Safeguards Order* ¶ 203

*   *   *   *

In 1997, the Commission recognized that clear biennial audit guidelines and standards would benefit the BOC, its affiliates, and market participants in all telecommunications markets In recognition of the importance of the section 272 audit, the Commission asked for public comment and received it However, it never publicly acted on that input and never provided clear and rigorous rules designed to ensure that violations of section 272 are detected and deterred The Commission should use this proceeding to fill this longstanding gap, and provide a precedent for all the biennial audits to be conducted in the future, including a re-audit of Verizon.

V. CONCLUSION

For the reasons stated, the Commission should penalize Verizon for its lack of compliance with section 272, and should immediately re-audit Verizon using appropriate procedures and standards

Respectfully submitted,

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April 8, 2002

CERTIFICATE OF SERVICE

I hereby certify that on this 8th day of April, 2002, I caused true and correct copies of the forgoing Comments of AT&T Corp. to be served on all parties by mailing, postage prepaid to their addresses listed on the attached service list

Dated April 8, 2002
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